Office of Chief Counsel
Internal Revenue Service

memorandum

CC: [redacted]:TL-N-3848-99
[redacted]

date: August 30, 1999

to: District Director, [redacted]
Attn: Case Manager [redacted]
Senior Team Coordinator [redacted]
Assistant Team Coordinator [redacted]

from: District Counsel, [redacted] District

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subject: [redacted]
EIN: [redacted]
Taxable Year Ended: [redacted]
POA: [redacted]

Non-Docketed Large Case Opinion: SI & CEP[1]

ISSUE: Where a son, [redacted], is the executor of his father's estate and trustee of numerous family trusts, (but not the trustee of the specific trust at issue, in a U.S. Tax Court proceeding, with respect to his father's estate tax liability), is the payment of the settlement amount of his father's estate tax liability and associated interest an allowable expense deduction of the son, under I.R.C. §§ 162, 212 or otherwise, if the payment was allegedly made to safeguard the son's and the family's reputation?

CONCLUSION: The claimed expense is not deductible. The son was simply the executor of the estate. He was not the attorney who developed the [redacted] trusts, he was not the settlor of the [redacted]

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[1] This opinion is that of District Counsel, [redacted]. A copy of this opinion is being sent to the national office for post-review and coordination purposes. If Field Service Advice results or any recommendations or modifications are made by the national office, we will so inform you, and modify our advice to you accordingly. We will do this, either orally or by supplemental memorandum, depending on the extent of any such recommendations or modifications, if any.

trusts, and, he was not the trustee of any of the [redacted]s trusts which were at issue in the estate U.S. Tax Court proceeding. Consequently, as a factual matter the son's own business reputation was not implicated in his father's estate Tax Court proceeding, whose settlement amount the son paid. Given the fact that the trial already was well publicized, at the time it was settled, it is logical to conclude that avoiding bad publicity for the family was not the main reason for the settlement, or even a very important reason. It is logical to conclude instead that the true reason [redacted] paid is that he would have had to pay anyway. The son's representative admits that the son anticipated that if the estate tax liability was not paid, the IRS would have gone after the son, as one of the beneficiaries of the [redacted] trust, under transferee liability principles. Even if avoiding bad publicity for the family was the true reason for the payment, the origin of the claim is a family, personal matter, non-deductible under the origin of the claim doctrine.

FACTS: In [redacted], [redacted] ("[redacted]") [redacted], [redacted]'s father, died, at the age of [redacted]. At the time of his death, [redacted] was the patriarch of the [redacted]-dollar family empire whose holdings included [redacted] and [redacted]. The family's fortune, at the time, was estimated by [redacted] at $[redacted] U.S. dollars. Yet, as a result of a complex foreign trust arrangement[2], reportedly, developed many years before by [redacted] attorney [redacted][3], no estate tax liability was paid or reported in the filed estate tax return.

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[2]As part of the settlement of [redacted], Deceased, [redacted], Docket No. [redacted], in the U.S. Tax Court, the estate tax liability case, [redacted], Executor of the [redacted], Deceased, and the Service entered into a Closing Agreement. In said agreement, the parties agreed, inter alia, that there were [redacted] separate and distinct trusts created by a document entitled "[redacted] for [redacted] Trusts: dated [redacted] in the [redacted], in the [redacted], one of the [redacted], by and between [redacted], as Settlor thereof, and [redacted], as Trustee thereof. A copy of this Closing Agreement is enclosed as Exhibit A.

[3] [redacted], reportedly, was a long-time legal adviser to the [redacted] family. He is a [redacted] on [redacted] and a [redacted]. [redacted], reportedly, has tangled often with the Service. His law firm is [redacted].

[redacted] was the executor of [redacted]'s estate, but he was not the settlor[4] or the trustee[5] of the specific [redacted] trusts at issue[6], in U.S. Tax Court docket No. [redacted]

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[4]It is established by the Closing Agreement that [redacted], a citizen and resident of [redacted], was the sole and exclusive settlor of the [redacted] Trusts, and no other individuals or entities acted in such capacity, directly or indirectly. See Exhibit A: Closing Agreement, pgs. 2-3, ¶¶ 2.A and 2.B.

[5]It is established by the Closing Agreement that [redacted] was the initial trustee of the [redacted] Trusts, succeeded thereafter by [redacted], [redacted] and [redacted] and [redacted] ([redacted]) [redacted], respectively. During the time periods in which [redacted], [redacted], [redacted] and [redacted] ([redacted]) [redacted] served as trustee of the [redacted] Trusts, such entities, and no other individuals or entities, were the sole, exclusive and independent trustees, de facto or de jure, of the [redacted] Trusts. See Exhibit A: Closing Agreement, pgs. 3-4, ¶¶ 2.C and 3.A.

[6]This would be true, at least, until [redacted] when [redacted] died. Whether [redacted] ever became the trustee of any of the [redacted] trusts, or of a residuary trust whose assets originated in the [redacted] trusts, subsequently to his father's death is not clear. A list of the trusts that paid [redacted] trustees fees in [redacted], as reported in his [redacted] return, is enclosed as Exhibit C. None of the trusts carry the designation [redacted] or anything that would disclose that they are related to the [redacted] trusts. This makes sense as the examining team has explained to the undersigned that all of these trusts **are domestic trust. It follows, that they are not the [redacted] foreign trusts.** On the other hand, as many of the listed trusts are "residuary" trusts, the possibility exists that one or more of these trusts are residuaries of assets originating in the [redacted] original trusts. Be that as it may be, what appears to be clear is that [redacted] was not the trustee of any of the [redacted] trusts, at least, for any of the relevant times at issue, e.g., from inception of the [redacted] **foreign trusts** to the time when his father died. Consequently, even if he later became the trustee of a foreign trust or the trustee of a residuary trust containing funds from a foreign trusts, which remains to be alleged or shown, [redacted]'s own reputation as a trustee would not be logically affected by any determinations which the Tax Court may have reached with respect

with respect to the estate tax liability of [redacted].

In a 90-day letter, a statutory notice of federal estate tax deficiency, issued in [redacted], the Internal Revenue Service asserted that the foreign trust(s) was (were) a "sham" and the [redacted] estate should have been valued at about $[redacted], creating a federal estate tax liability of about $[redacted]. In addition to the estate tax liability, other related [redacted] family entities and individuals were under examination or being considered for examination by the Internal Revenue Service. Both the Service and the [redacted]' considered that the ultimate determination of the legitimacy of the foreign trusts arrangement at issue in the estate tax case would impact on the legitimacy of other [redacted] family members trust arrangements, because the basic plan and modus operandi for all of them is believed to be similar.

The estate tax liability trial became docketed in the U.S. Tax Court as Docket No. [redacted]. The Service faced a number of difficult procedural issues going into trial due to the fact that the [redacted] family trusts, that pertained to [redacted]'s estate tax liability, were [redacted] trusts protected by the [redacted]' secretive banking laws; due to the fact that the original settlor of the trusts was a [redacted] citizen, unavailable for trial; due to the fact that the inflows and outflows of funds, over such a complicated trust arrangement consisting of [redacted] separate interrelated trusts could not be determined; and due to the fact that the ultimate management and control of the trusts could not be shown without establishing the flows of funds and in the absence of trust documentation, apparently, shielded by the [redacted] bank secrecy laws; and, due, perhaps, to other similar reasons. Accordingly, in the end, settlement of the case was deemed advantageous to the Service.

A negotiated settlement was reached just prior to the trial of the estate tax case in U.S. Tax Court. This settlement resolved all estate-related and foreign trust issues as described in the Closing Agreement and Final Determination Covering Specific Matters dated [redacted] (the "Closing Agreement") (copy attached as Exhibit A) that was executed in connection with this settlement. Pursuant to paragraph 6 of the Closing Agreement, [redacted] accepted personal liability for, and personally paid the settlement amount of $[redacted] of which

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to the actions of his father or the action of the various foreign entities that acted as independent trustees prior to his father's death, had the estate Tax Court case proceeded to trial and decision.

$[redacted] represented tax with the balance being interest.

The following is what the Closing Agreement provides at paragraph 6, with respect to payment of the liability and interest accrued thereon:

> "It is further stipulated and agreed that, **in light of the uncertain collectibility of any deficiency hereunder (including statutory interest thereon), [redacted], individually and as Executor of the Estate of [redacted], shall be personally liable for the payment of the deficiency hereunder (including statutory interest thereon) pursuant to Section 2002 of the Code.** The payment of such deficiency (including statutory interest thereon) shall not constitute a transfer under Chapters 12 or 13 of the Code notwithstanding **any theory of transferee liability which could be advanced."** [**Emphasis added;** Closing Agreement pg. 6, ¶ 6].

For the taxable year ended December 31, [redacted] and [redacted] filed a joint income tax return on Form 1040. Enclosed as Exhibit B. The Form 1040 contains two Schedule Cs. On one Schedule C, [redacted] is listed as the proprietor. His principal business is listed as Fiduciary/Trustee/Executor. Gross receipts of $[redacted] are listed on line 1 of Part I. The sources of the reported gross receipts are not disclosed in the return, but they have since been disclosed pursuant to IDR. See Exhibit C. On line 27 in Part II, of the return, other expenses of $[redacted] are shown. Lines 29 and 31 show a resulting net loss of $[redacted]. See Exhibit B.

Revenue Agent [redacted] questioned the propriety of the claimed $[redacted] deduction in Form 4564- Information Document Request Number [redacted] dated [redacted] (copy enclosed as Exhibit D). Taxpayers' representative Attorney [redacted] responded in a letter dated [redacted] (copy enclosed as Exhibit E). In this letter, [redacted] explains why [redacted] accepted personal liability for and personally paid the settlement account. "[redacted]"

Further [redacted] further explains that "[redacted]"

[redacted]

Taxpayer claims that the settlement amount was paid to avoid notoriety that might damage his reputation. The potential litigation was well publicized in the local media. The details of the IRS's legal position was also detailed in these accounts. for example, the articles in the [redacted] and [redacted] issues of [redacted]. Also similar issues of the [redacted]. Additional media sources could be cited. See Exhibit F.

We need to note that [redacted], the executor of his father's estate, died [redacted], at the age of [redacted]. However, his [redacted] income tax liability remains pending. To the outside world, [redacted] was perhaps best known for his role in developing the [redacted]; putting his family's [redacted] that some call the [redacted]; and for the annual listing of his [redacted]. At the time of his death, he was board chairman of [redacted] and one of [redacted]. Other members of the [redacted] clan continue to carry on the [redacted] family's business and civic activities. The family's fabulous wealth and the talent and energy of its remaining members ensure that the family will remain prominent in the [redacted] area in the fields of business, philanthropy and politics, for the foreseeable future.

DISCUSSION AND LEGAL ANALYSIS: I.R.C. § 162 of the Internal Revenue code provides, in part, for the deduction of all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business.

I.R.C. § 163 of the Internal Revenue code provides, in part, that for taxpayers other than a corporation a deduction for investment interest for any taxable year shall not exceed the net investment income of the taxpayer for the taxable year.

I.R.C. § 212 of the Code provides, in part, for the deduction by individuals of all ordinary and necessary expenses paid or incurred during the taxable year for the production or collection of income and for the management, conservation or maintenance of property held for the production of income.

I.R.C. § 262 states that except as otherwise expressly provided in this chapter, no deduction shall be allowed for personal, living, or family expenses.

I.R.C. § 275 states that no deduction shall be allowed for the following taxes "***(3) Estate, inheritance, legacy, succession, and gift taxes.***"

Based solely on the facts and materials submitted, the examination team is of the opinion that the taxpayer's claimed deduction of $[redacted] is not allowable under I.R.C. § 162 or any other section of the Internal Revenue Code for the following reasons. The Examination Team considers the following factors to be material to this determination.

1. The settlement amount paid is personal in nature. It stems from an obligation that has its genesis in a personal family obligation. The legal basis for this conclusion is the "origin of the transaction" (or claim) doctrine, as enunciated in Woodward v. Commissioner, 397 U.S. 572 (1970); United States v. Gilmore, 372 U.S. 39 (1963); and similar cases.

2. The examiners do not accept the taxpayer's statement that payment of the claimed amount precluded the release of personal information which may have damaged the taxpayer's reputation. Numerous media sources, including newspaper and magazine articles and radio and television stories both before and after the settlement agreement provided very specific details of the issues and family members involved in the contemplated Tax Court case. See enclosed Exhibit F. Furthermore, since the taxpayer states that the Government had no evidence to support its allegations, the examiners find it difficult to understand what damaging information could have been produced if the case had proceeded to trial before the Tax Court.

3. The specific intent of the Internal Revenue Code is not to allow a deduction for federal taxes as enumerated in I.R.C. § 275.

4. The Examiners believe to allow the claimed amount as a deduction would subvert the intent of the negotiations which caused the Internal Revenue Service to enter into the settlement agreement.

We agree with the Service examiners. Payment of a judgment or settlement of a suit or claim arising out of a business matter is generally deductible as a business expense. A deduction, however, may be denied where the origin of the claim is a capital transaction, or where, as it is here, it is a personal matter.

The basic principle is that the origin and character of the claim with respect to which the expense is incurred determines whether judgment and settlement payments are deductible. See United States v. Gilmore, 372 U.S. 39, 11 AFTR 2d 758, 9 L Ed 2d 570, 63-1 USTC ¶ 9285 (1963).

In the instant case, the claimed expense is not deductible. [redacted], the son, was simply the executor of the estate. He was not the attorney who developed the [redacted] trusts, he was not the settlor of the [redacted] trusts, and, he was not the trustee of any of the [redacted]s trusts which were at issue in the estate U.S. Tax Court proceeding. Consequently, as a factual matter the son's own business reputation was not implicated in his father's estate Tax Court proceeding, whose settlement amount the son paid.

There is a Court of Appeals case that illustrates the law applicable in this case. The case is McDonald v. Commissioner, 592 F2d 635 (2d Cir. 1978);[42 AFTR 2d 78-5797; 78-2 USTC ¶ 9631], revg & remg TC Memo 1977-202, PH TCM ¶ 77202 (1977). In McDonald, the Second Circuit Court of Appeals held that taxpayer could not deduct as a business expense the cost of settling a will contest where the origin of the taxpayer's rights under the will was not his law practice but his personal relationship with the testator. The fact that his primary purpose in agreeing to the settlement was to protect his reputation as a lawyer did not matter since it is the origin of the claim that controls. To be noted is the fact that, the Tax Court in McDonald, whose decision the Tax Court reversed, had held for the taxpayer on the basis of the primary purpose test, i.e., although the will contest did not arise out of taxpayer's law practice, his primary purpose in settling it was to protect his law practice. The Second Circuit Court of Appeals held that the U.S. Tax Court's use of the primary purpose test was wrong, that the proper standard to be applied was the origin of the claim test.

In addition, even if the origin of the claim test was not dispositive, the known facts contradict the taxpayer's argument that his primary reason for assuming his father's estate tax liability was to preserve his business reputation. Given the fact that the dispute between the [redacted]'s and the upcoming trial already was well publicized in the media, before the time when it was settled, it is logical to conclude that avoiding bad publicity for the family was not the main reason for the settlement, or even a very important reason.

Conversely, it is logical to conclude instead that the true reason [redacted] paid is that he would have had to pay anyway. The son's representative admits that the son anticipated that if the estate tax liability was not paid, the IRS would have gone after

the son, as one of the beneficiaries of the [redacted] trust, under transferee liability principles. At page 2 of [redacted]'s letter dated [redacted], taxpayer's representative admits, as follows:

[redacted]

Be that as it may be, even if avoiding bad publicity for himself and for his family was a true reason for the payment, the origin of the claim is a family, personal matter, which is non-deductible under the origin of the claim doctrine. It was not a business expense.

This concludes our legal advice in this matter. We are closing our file, subject to the qualifications previously stated that we will communicate to you any modifications or recommendations that are made by our national office. If you have any questions, please contact the undersigned at ([redacted]) [redacted], extension [redacted].

[redacted]
District Counsel

By: [redacted]
Special Litigation Assistant

Attachments:
(1) Closing Agreement dated [redacted] together with copy

of decision (Exhibit A);
(2) Copy of IDR [redacted] dated [redacted] with attached copy of [redacted] and [redacted] Form 1040, U.S. Individual Income Tax Return (Exhibit B);
(3) Copy of [redacted] response to IDR [redacted] with attached IDRS dated [redacted] with attached [redacted] Trustee Fees Received in [redacted] (Exhibit C);
(4) Copy of [redacted] IDR [redacted] (Exhibit D);
(5) Response letter to [redacted] consisting of a letter dated [redacted] from [redacted] (Exhibit E);
(6) Print out of numerous news articles publicizing the tax controversy between the [redacted] and the Service (Exhibit F).

(Distribution below is made without attachments, except, where otherwise noted)

CC: District Counsel, [redacted]

CC: Assistant Regional Counsel, [redacted] (Large Case) [redacted]

CC: Assistant Regional Counsel, [redacted] (TL) [redacted]

CC: Special Trial Attorney [redacted]
CC:[redacted]

CC:DOM:FS (2 copies with 2 complete sets of attachment)

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